



JOHN CHIANG
California State Controller

October 10, 2008

The Honorable Henry M. Paulson, Jr.
Secretary of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Mr. Secretary:

Thank you for your leadership in passing and implementing the Emergency Economic Stabilization Act of 2008. This legislation should help address the problems in the markets which have created financial turmoil and serious economic damage to California, our nation and, most recently, the domestic and international credit markets. However, while we continue to work through this crisis, I believe more needs to be done to increase investor confidence in the credit markets, specifically the huge Credit Default Swap (CDS) market. The lack of transparency in this market is affecting all major borrowers, including the State of California and is a major hurdle to restoring confidence to the credit markets. We are a frequent and sizable borrower in the credit markets. There is an active market in CDS for our State's debt. As a result, a dysfunctional market affects all Californians in the form of reduced efficiency and likely higher costs.

I have become increasingly convinced that to fully restore confidence in these markets, we must provide for transparency in and regulation of these privately-negotiated contracts that guarantee payment of one party's obligation should another party default. Estimated to be in the range of \$60 trillion, the CDS market basically operates as a backroom bet on the credit-worthiness of risky investments.

This market may work well when the economy is strong. But during times of economic uncertainty, the lack of information about the financial exposure of the parties from which they seek financial protection results in a standoff. Simply put, parties are reluctant to enter into contracts with other parties when there is no information available regarding the exposure of the parties from which they seek financial protection. This uncertainty cannot be fixed simply by flooding the market with federal funds. To truly restore confidence and liquidity in a market, we must provide transparency to the "price discovery" process needed for efficient functioning.

As you meet with financial institutions today, I propose that your office, working in conjunction with the Commodity Futures Trading Commission, explore classifying these CDS agreements as subject to regulation by the Commission and disclosure as liabilities on the balance sheets of all companies. Disclosure and registration would bring back transparency, improve confidence and increase liquidity in the market.

Secondly, as an incentive for action, I recommend that you consider suspending the execution of any new contract until the regulatory framework is in place. Without these protections, this shadow market operates as an unregulated gambling house in which the players may succeed in breaking the house if they are allowed to set the rules while playing with the public's money.

The CDS contracts were designed to provide credit insurance for a specific time period while avoiding the necessary regulation of the insurance industry. The important bottom line is that a solution for the CDS exposure of financial institutions has to be implemented in order to restore confidence in the credit markets. Integral to this solution is the improvement of transparency of counterparty risk.

In that respect, I encourage you to investigate the development of a clearing organization organized in the style of CME Clearing, which handles settlements on more than 90% of all futures and options traded in the United States. Clearing commodities contracts will be different from clearing CDS insurance contracts, but the regulatory framework and infrastructure necessary for success should be very similar. CME Clearing is not unfamiliar with the size of the CDS market – in fact, the value of trades settled through CME Clearing far exceeds the immense size of the CDS market. Development of such a settlement facility would significantly improve market transparency, control counterparty risk and improve the functioning of this burgeoning market without introducing thorny constitutional impairment of contract issues.

To be effective, your office should move swiftly to establish the agenda for the development of such a system. In the interim, I recommend that no new contracts be initiated until the framework for regulation is established, that capital and reserve requirements be established for this insurance product, and that all financial institutions be required to value and disclose to the market the CDS liabilities on their balance sheets to achieve a transparent market.

This financial crisis must be resolved. I do not believe that confidence and liquidity will be restored to the credit markets until the Credit Default Swap market is addressed in a clear and comprehensive manner. California could be a major beneficiary of this improved confidence -- but it will not be the only beneficiary. State and local governments, American businesses and the public at large need open, functional markets to conduct their business efficiently. You have the ability to initiate and lead the markets to this result.

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I encourage you to give this recommendation your early and earnest consideration.

Sincerely,

Original signed by,

JOHN CHIANG
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